

## Message Text

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ACTION EUR-12

INFO OCT-01 EA-10 IO-13 ISO-00 AID-05 CIAE-00 EB-08  
FRB-03 INR-10 NSAE-00 ICA-11 XMB-02 OPIC-03 SP-02  
LAB-04 SIL-01 OMB-01 NSC-05 SS-15 STR-07 CEA-01  
L-03 H-01 PA-01 /119 W  
-----008858 091842Z /45

P R 091752Z JUN 78  
FM AMEMBASSY LONDON  
TO SECSTATE WASHDC PRIORITY 7000  
TREASURY DEPT WASHDC PRIORITY  
INFO AMEMBASSY BONN  
AMEMBASSY BRUSSELS  
AMEMBASSY DUBLIN  
AMEMBASSY PARIS  
AMEMBASSY ROME  
AMEMBASSY TOKYO  
AMCONSUL BELFAST  
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USEEC ALSO FOR EMBASSY  
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USMTN

DEPARTMENT PASS FEDERAL RESERVE BOARD; TREASURY FOR  
DONALD E. SYVRUD, OASIA

E.O. 11652: N/A  
TAGS: EFIN, UK, PINT  
SUBJECT: NEW MEASURES TO CONTROL MONETARY GROWTH

SUMMARY: THE FINANCIAL PACKAGE, ANTICIPATED BY FINANCIAL  
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MARKETS (SEE LONDON 8999, PARAGRAPHS 8, 9 AND 10) WAS  
ANNOUNCED THURSDAY. IT RAISED THE MINIMUM LENDING RATE  
(MLR) TO 10 PERCENT, REIMPOSED THE CORSET, AND BUTTRESSED  
THESE FINANCIAL MEASURES WITH AN INCREASE IN THE EMPLOY-  
ERS' SURCHARGE ON NATIONAL INSURANCE, ALL OF WHICH WERE  
EXPECTED. END SUMMARY

1. THE MLR WAS INCREASED FROM 9 TO 10 PERCENT. SHORT-TERM RATES OF INTEREST HAVE IN FACT BEEN MOVING UP FASTER THAN THE ADMINISTERED MLR. IF THE BANK OF ENGLAND HAD SET MLR AT LAST FRIDAY'S TREASURY BILL AUCTION ACCORDING TO THE RECENTLY DISCARDED MARKET-RELATED FORMULA, IT WOULD HAVE RISEN 1/2 PERCENT AT THAT TIME.

2. THE SUPPLEMENTARY SPECIAL DEPOSIT SCHEME, OR "THE CORSET", WAS REINTRODUCED. IT WAS SUSPENDED AUGUST 11, 1977. THE CORSET PROVIDES THAT A PORTION OF ANY EXCESS GROWTH IN BANKS' INTEREST BEARING ELIGIBLE LIABILITIES (IBELS) BE PLACED INTEREST-FREE AT THE BANK OF ENGLAND. THE PERMISSIBLE (OR RATHER PENALTY-FREE) LEVEL OF IBELS FOR THE AVERAGE OF THE THREE MONTHS OF AUGUST, SEPTEMBER AND OCTOBER WILL BE 4 PERCENT ABOVE A BASE LEVEL CALCULATED AS THE AVERAGE OF THE 6 MONTHS BETWEEN NOVEMBER 1977 AND APRIL 1978. IF THE 3-MONTH AVERAGE OF INDIVIDUAL BANK'S IBELS EXCEED THE PENALTY-FREE MAXIMUM BUT BY NO MORE THAN 1 PERCENT, IT MUST DEPOSIT 5 PERCENT OF THE EXCESS WITH THE BANK OF ENGLAND IN NOVEMBER. IF IT EXCEEDS THE PENALTY-FREE MAXIMUM BY MORE THAN 1 PERCENT BUT NO MORE THAN 3 PERCENT, IT MUST DEPOSIT 25 PERCENT OF THE EXCESS OVER THE MAXIMUM. IF IT EXCEEDS THE PENALTY-FREE MAXIMUM BY MORE THAN 3 PERCENT, 50 PERCENT OF THE EXCESS MUST BE DEPOSITED.

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3. THE BASE PERIOD AVERAGE OF ALL BANKS' IBELS WAS 28,000 MILLION POUNDS, WHILE THE MAY 17 LEVEL WAS 30,096 MILLION POUNDS, 7.5 PERCENT ABOVE THE BASE LEVEL. IT IS LIKELY, THEREFORE, THAT BANKS WILL BE FORCED TO REDUCE THEIR IBELS SHARPLY OVER THE NEXT FEW MONTHS. THIS REDUCTION IS NOT NECESSARILY DRACONIAN, AS BANKS HAVE APPARENTLY BEEN BUILDING UP THEIR IBEL BASE OVER THE PAST FEW MONTHS IN ANTICIPATION OF THE CORSET'S REINTRODUCTION. IBELS HAVE, IN FACT, GROWN BY 5.1 PERCENT OVER THE TWO BANKING MONTHS ENDED MAY 17, WHILE ATTEMPTS TO POSITION HAVE OCCASIONALLY RESULTED IN A DISRUPTED MONEY MARKET (SEE LONDON 8252 FOR EXAMPLE).

FYI: THIS WOULD HAPPEN FOR EXAMPLE IF MARKET FORCES LED SOME BANKS TO REDUCE INTERBANK LOANS (WHICH ARE ACCOUNTING OFFSETS TO THEIR IBELS), WHILE INCREASING THEIR LOANS AT CALL TO THE DISCOUNT MARKET (WHICH ARE NOT). THE DISCOUNT MARKET COULD THEN USE THE CALL MONEY TO ACQUIRE C.D.'S ISSUED BY FORMER BORROWERS IN THE INTERBANK MARKETS (AS SUBSTITUTING C.D.'S FOR INTERBANK BORROWING NEED NOT OFFSET A BANK'S IBEL POSITION).

4. THE FINANCIAL MARKETS REACTED POSITIVELY TO THE MEAS-

URES, AS GILT PRICES ROSE ACROSS ALL MATURITIES AND THE GOVERNMENT BROKER SOLD BOTH TAP STOCKS IN APPRECIABLE QUANTITIES. MARKET SOURCES ESTIMATE THAT 400 MILLION POUNDS IN GILTS WERE SOLD THURSDAY AFTERNOON. EARLY THIS MORNING THE LONG TAP, THE EXCHEQUER 12 PERCENT 1998, WAS DECLARED EXHAUSTED. 800 MILLION POUNDS OF THE LONG

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LAB-04 SIL-01 OMB-01 NSC-05 SS-15 STR-07 CEA-01  
L-03 H-01 PA-01 /119 W  
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P R 091752Z JUN 78  
FM AMEMBASSY LONDON  
TO SECSTATE WASHDC PRIORITY 7001  
TREASURY DEPT WASHDC PRIORITY  
INFO AMEMBASSY BONN  
AMEMBASSY BRUSSELS  
AMEMBASSY DUBLIN  
AMEMBASSY PARIS  
AMEMBASSY ROME  
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TAP HAD BEEN ISSUED APRIL 27 IN PARTIALLY PAID FORM. OF THE 96 POUNDS (PER 100 POUNDS NOMINAL VALUE) ASKED AT IS-SUE, 30 POUNDS WAS PAYABLE AT THE APPLICATION, 25 POUNDS ON MAY 15, AND 31 POUNDS JUNE 7.

5. THE PRINCIPAL CHANGE IN FISCAL POLICY ANNOUNCED BY THE CHANCELLOR WAS A 2.5 PERCENTAGE POINT INCREASE IN THE

SURCHARGE ON THE EMPLOYERS' NATIONAL INSURANCE CONTRIBUTION. EFFECTIVE OCTOBER 2, 1978, THE NEW SURCHARGE IS EXPECTED TO BOOST GOVERNMENT REVENUES BY 0.6 BILLION POUNDS LIMITED OFFICIAL USE

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AND REDUCE THE PUBLIC SECTOR BORROWING REQUIREMENT (PSBR) BY 0.5 BILLION IN FY 78/79. THE DIFFERENCE BETWEEN THE REVENUE AND PSBR EFFECTS IS DUE TO THE LOWER LEVEL OF ECONOMIC ACTIVITY IN THE WAKE OF THE SURCHARGE INCREASE. IN THE CURRENT FISCAL YEAR THE NEW SURCHARGE SHOULD OFFSET THE IMPACT ON PSBR OF THE REVENUES LOST BECAUSE OF THE AMENDMENTS TO THE APRIL BUDGET (SEE LONDON 7307), THEREBY RESTORING THE BUDGETARY STIMULUS TO ITS ORIGINAL SIZE.

IN THE U.K., BOTH EMPLOYERS AND EMPLOYEES CONTRIBUTE TO THE NATIONAL INSURANCE PROGRAM (SIMILAR TO U.S. SOCIAL SECURITY). THE FOLLOWING TABLE DESCRIBES BOTH THE RATES OF CONTRIBUTION FOR BOTH GROUPS:

|                                | EMPLOYEE | EMPLOYER |
|--------------------------------|----------|----------|
| PERCENT OF SALARY              | 6.5      | 10.0     |
| MINIMUM ANNUAL SALARY (POUNDS) | 910      | 910      |
| MAXIMUM ANNUAL SALARY (POUNDS) | 6,240    | 6,240    |

TO THE EMPLOYER'S 10 PERCENT MUST BE ADDED A 2 PERCENTAGE POINT SURCHARGE FIRST INTRODUCED IN MARCH 1977, AND NOW THE ADDITIONAL 2.5 PERCENTAGE POINT SURCHARGE EFFECTIVE IN OCTOBER. THIS BRINGS THE TOTAL EMPLOYER'S CONTRIBUTION PLUS THE SURCHARGE TO 14.5 PERCENT OF THE RELEVANT WAGE BILL. IT SHOULD BE NOTED THAT BOTH EMPLOYEE AND EMPLOYER CONTRIBUTIONS WERE INCREASED LAST APRIL TO THEIR CURRENT BASIC LEVELS FROM 5.75 AND 8.75 PERCENT, RESPECTIVELY. THUS, FROM THE EMPLOYER'S POINT OF VIEW, THE TAX RATE ON EACH EMPLOYEE WILL HAVE RISEN BY JUST OVER A THIRD BETWEEN MARCH AND OCTOBER, 1978

6. THE CONFEDERATION OF BRITISH INDUSTRY (CBI) REACTED VERY STRONGLY TO THE NEW SURCHARGE. IT ESTIMATED THAT UNEMPLOYMENT WILL RISE BY 100,000 WHILE RETAIL PRICES INCREASE BY 1 TO 1.5 PERCENT WITHIN A YEAR OF THE EFFECTIVE DATE OF THE SURCHARGE. CBI DIRECTOR GENERAL JOHN METHVEN ALSO CRITICIZED THE SURCHARGE AS DESTRUCTIVE OF BUSINESS CONFIDENCE SINCE IT WOULD REDUCE PROFITABILITY, DAMAGE FUTURE INVESTMENT AND IMPAIR BRITAIN'S COMPETITIVE POSITION ABROAD. THE CBI CRITICISM NOTED THE SELECTIVE IMPACT THAT THE SURCHARGE INCREASE, IN CONTRAST TO A VAT

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INCREASE, WOULD HAVE ON LABOR-INTENSIVE INDUSTRIES. IT WAS NOTED MOREOVER THAT A VAT INCREASE COULD HAVE BEEN REBATED AT THE BORDER TO HELP PRESERVE EXPORT COMPETITIVENESS. THE MEASURE ALSO DREW FIRE FROM SOME TRADE UNION LEADERS AS A DIRECT TAX ON EMPLOYMENT (MOSS EVANS, TRANSPORT AND GENERAL WORKERS) AND A DETERRENT TO NEW INVESTMENT.

7. SOURCES INDICATE THAT HMG TAKES EXCEPTION TO CBI'S ESTIMATE ON PRICES AND UNEMPLOYMENT. THE OFFICIAL VIEW APPEARS TO BE THAT PRICES ARE LIKELY TO INCREASE BY ABOUT 0.75 PERCENT, THE RISE BEING SPREAD OVER TWO YEARS. THE EMPLOYMENT IMPACT IS HARDER TO ASSESS, BUT ACCORDING TO THESE SOURCES, IT IS

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P R 091752Z JUN 78  
FM AMEMBASSY LONDON  
TO SECSTATE WASHDC PRIORITY 7002  
TREASURY DEPT WASHDC PRIORITY  
INFO AMEMBASSY BONN  
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UNLIKELY TO DO MORE THAN PREVENT THE INCREASED ACTIVITY, AND THEREFORE EMPLOYMENT, WHICH COULD HAVE BEEN STIMULATED AS A RESULT OF THE BUDGET AMENDMENTS. NEVERTHELESS, THE NEW SURCHARGE REPRESENTS A DIRECT INCREASE IN OVER-ALL LABOR COSTS. AS SUCH IT WILL REDUCE CORPORATE CASH FLOW AND PROVIDE STRONG MOTIVATION TO BUSINESS TO RECOUP SOME OF THIS LOSS THROUGH HIGHER PRICES.

IN MACROECONOMIC TERMS, THE REVENUES BROUGHT IN BY THE SURCHARGE COULD ENSURE THAT THE GOVERNMENT REMAINS WITHIN REACH OF ITS PSBR TARGET OF 8.5 BILLION POUNDS IN LIMITED OFFICIAL USE

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THE CURRENT FISCAL YEAR. HOWEVER, THE RATE OF INCREASE IN PRIVATE INVESTMENT IN 1979 MAY BE EFFECTED PARTICULARLY IN CONJUNCTION WITH FINANCIAL ELEMENTS IN THE PACKAGE.

8. COMMENT: THE RATIONALE BEHIND THE COMPOSITION AND TIMING OF THE PACKAGE SHOULD BE SEEN IN LIGHT OF WHAT HAPPENED IN THE SUMMER OF 1976. INTEREST RATES WERE HELD DOWN, GILT SALES FELL OFF, MONEY SUPPLY EXPLODED WELL BEYOND THE OFFICIAL TARGETS, AND A STERLING CRISIS ENSUED. THE TREASURY AND BANK OF ENGLAND WERE DETERMINED THAT THIS CHAIN OF EVENTS SHOULD NOT BE REPEATED. FOREIGN EXCHANGE AND GILTS MARKETS WERE BECOMING NERVOUS (SEE PARAGRAPH 8 AND 9, LONDON 8999). THERE WERE FEARS OF A POTENTIAL STERLING CRISIS IN SUMMER OR EARLY AUTUMN.

THE PACKAGE IN LARGE PART AIMED TO PREVENT A CRISIS BY TAKING PRESSURE OFF THE GILT MARKET (BY RAISING 600 MILLION POUNDS THROUGH THE EMPLOYERS' CONTRIBUTION), HELPING ASSURE THAT GILT OFFERINGS WOULD BE TAKEN (BY RAISING INTEREST RATES) AND REDUCING GROWTH OF THE MONEY SUPPLY (BY THE CORSET).

THE PERCEIVED ECONOMIC COST COMES MOST DIRECTLY THROUGH CUTTING CASH FLOW AND PROFITS IN THE PRIVATE SECTOR, EVENTUAL PRICE RISES WHERE FIRMS CAN PASS ON THE INCREASE, AND MAKING FUNDS TO THE PRIVATE SECTOR AND INDIVIDUALS MORE EXPENSIVE AND HARDER TO OBTAIN. THE GOVERNMENT CONSIDERED RAISING VAT, BUT REJECTED THIS BECAUSE IT WOULD HAVE INCREASED RETAIL PRICES IMMEDIATELY, I.E., BEFORE THE VERY LIKELY POSSIBILITY OF AN OCTOBER ELECTION. THE OTHER OBVIOUS ALTERNATIVE -- EXPENDITURE CUTS -- WAS SIMPLY NOT A VIABLE POLITICAL OPTION.

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## Message Attributes

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**TAGS:** EFIN, PINT, UK, US, (CARAMANLIS, CONSTANTINE)  
**To:** STATE TRSY MULTIPLE  
**Type:** TE  
**vdkgvkey:** odb://SAS/SAS.dbo.SAS\_Docs/d2de428c-c288-dd11-92da-001cc4696bcc  
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